Specimen Answer – Question 26 2010 trial

Monetary policy involves influencing the level of economic activity through the adjustment of the interest rates by the Reserve bank of Australia. The three major internal objectives of government economic policy are economic growth (increasing GDP), the achievement of full employment and the minimising of inflation.

Monetary policy is implemented through open market operations which occur in the Exchange Settlement Account, which is held with the Reserve Bank and the commercial banks. The Reserve bank sets the cash rate (the interest rate in the ESA) on a monthly basis. To maintain the cash rate at the desired amount the RBA either buys or sells Commonwealth Government Securities or repurchase agreements (repos) to the banks in the ESA. If the money supply is increasing, putting downward pressure on the money supply, the RBA will sell repos in the market. This will reduce the money supply and maintain the cash rate at the appropriate level.

A lower cash rate would lower the cost of borrowing and put downward pressure on other interest rates. This expansion of monetary policy would then allow the economy to grow as increased investment would now follow (ceterus paribus). Similarly cheaper borrowed funds would increase consumption, but decrease savings. Cash flows would increase as the cost of credit declines. With more money available asset prices would rise, pushing up the prices of houses, shares and other investments. Lower interest rates would however lower the exchange rate as foreign owners of capital would seek better returns for their funds in other countries. However inflationary expectations may rise with the stronger demand.

The cash rate has fluctuated significantly over the last few years as the RBA has attempted to achieve economic growth. Up until 2007, the cash rate had risen to 7.25% (ABS & RBA) as the authority tried to reduce demand. With the start of the GFC, the cash rate dropped quickly to 3.25% in 2009 (ABS & RBA), in an attempt to push up economic growth as it dropped from 3.7% for the financial year 2007-08 to 1.3% in 2008-09.

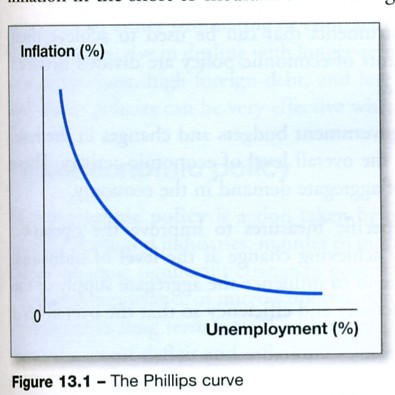
Due to the problem of a liquidity trap, where low interest rates do not encourage investment, it was necessary to supplement this will a strong budget deficit to enable the economy to grow.

As economic growth has continued into the current year, the RBA has raised “cash rates towards levels that would be consistent with interest rates .... close to the average experience” (Glenn Stevens).

However as growth as risen, so the RBA has been faced with the conflicting dilemma of inflation and unemployment. This means to overcome inflation higher unemployment can result.

When the economy was increasing rapidly before the GFC, underlying inflation (the removal of “one off” seasonal or volatile factors from the headline inflation) reached 4.3%, yet unemployment was only 4.2%. However post GFC, unemployment rose to 5.8% with headline inflation down to 1.5% in 2008-09.

This inverse relationship between inflation and unemployment is known as the Phillips Curve and is shown in the graph below



When inflation is high, unemployment is low and visa versa.

The RBA uses a process called inflation targeting, whereby it aims to achieve an inflation target of 2-3% with the year. Inflation outside this range means that the cash rate will be adjusted to achieve its desired range.

There are a number of types of unemployment:- cyclical, structural, seasonal, frictional, hidden and long term. The most significant in a recession is cyclical (the rise in unemployment due to a lack of aggregate demand) which has been helped by the lower interest rates. Since the demand for labour is a derived demand, increasing economic growth will lead to a rise in the demand for labour. Unemployment is expected to drop to 5% in 2010-11 (Budget paper #1) as economic growth proceeds.

Structural unemployment (the mismatch of skills with the jobs offered by employers) cannot be targeted by monetary policy however. Here fiscal policy or micro-economic reform

Frictional and seasonal unemployment are minor components and are generally not targeted by the budget. However, hidden unemployment can be reduced by increasing aggregate demand and as a result of recent policies the participation rate has increased. Fiscal policies to overcome long term unemployment include subsidies to employers to take on these workers and education/skills programs discussed earlier.